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Evan M. Gilbert

UNNECESSARY REFORM: THE FALLACIES WITH AND ALTERNATIVES TO SEC REGULATION OF HEDGE FUNDS

EVAN M. GILBERT[1]

I. INTRODUCTION

In 1949, Alfred Winslow Jones, a sociologist by trade, created perhaps the most controversial money management vehicle of modern times: the hedge fund.[2] Jones formed an investment partnership which used leveraged money to take long

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[1] J.D., 2008, University of Minnesota Law School; M.D.R., 2008, Pepperdine University; B.S., 2004, Arizona State University. I would like to thank Jean Loh for her unwavering support and valued assistance.

[2] Peter Landau, *Alfred Winslow Jones: The Long and Short of the Founding Father*, THE INSTITUTIONAL INVESTOR, August 1968.

positions in undervalued stocks and short positions in overvalued stocks.[3] Designed as a means of protecting investments against market risk, Jones described the new strategy as a speculative tool used for conservative purposes.[4] As he explained it, "[t]he logic of the idea was very clear. It was a hedge against the vagaries of the market."[5]

Jones's partnership operated in relative obscurity until 1966, when Fortune Magazine published an article detailing its investment success.[6] The article noted that the new investment model had outperformed that year's top performing mutual funds by forty-four percent, and the top performing mutual funds over the past five years by eighty-five percent.[7] The publicity quickly propelled hedge funds to the forefront of the financial world, and although the bear markets of the 1970s drove the industry back into obscurity,[8] the past nineteen years have seen it revitalized.[9] Today, with recent estimates indicating that well over 9,000 funds are managing more than $1.4 trillion in assets,[10] hedge funds seem to have solidified themselves as one of the most significant players in our financial system.[11]

The industry's tremendous growth, however, has rendered it the target of some substantial criticism.[12] A number of commentators have begun to question the soundness of exempting hedge funds from the regulatory oversights of federal securities laws.[13] With some going so far as to refer to the industry as a "dark, shadowy world with no legitimacy,"[14] these critics express three basic concerns. Their primary complaints center on the notion that a failed hedge fund could cause

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[3] Mario J. Gabelli, *The History of Hedge Funds—The Millionaire's Club*, GAMCO INVESTORS, INC., Oct. 25, 2000, http://www.gabelli.com/news/articles/mario-hedge_102500.html (last visited Aug. 8, 2008).

[4] Landau, *supra* note 2, at 20.

[5] *Id.*

[6] Gabelli, *supra* note 3.

[7] *Id.*

[8] Many of the new hedge funds of the late 1960s and early 1970s abandoned Jones's long-short strategy. Gabelli, *supra* note 3. The financial markets in the late-1960s were booming which meant that shorting even a small percentage of an investment portfolio would significantly restrain earnings. *Id.* As a result, most funds turned to significantly riskier strategies based on long-term leverage. Jim McWhinney, *A Brief History of the Hedge Fund*, INVESTOPEDIA, http://www.investopedia.com/articles/mutualfund/05/HedgeFundHist.asp (last visited Apr. 8, 2008). Without sufficient short positions to protect against a downturn, hedge funds suffered substantial losses when the market soured in 1969 and 1970. *Id.* The situation worsened a few years later as the savage 1973 and 1974 bear market produced major casualties within the industry. *Id.* Although a few prudently managed funds survived, the vast majority collapsed. *Id.*

[9] In 1990, the burgeoning industry was revitalized when the financial world learned of the enormous success enjoyed by hedge fund superstars George Soros and Julian Robertson. Gabelli, *supra* note 3.

[10] Shivani Vora & Mark Gongloff, *Hedge-Fund Milestones*, WALL ST. J., Jan. 29, 2007, at A14.

[11] *See id.* (noting that the total amount of assets controlled by hedge funds represents five percent of all assets under management in the United States).

[12] *See, e.g.*, *Group Suggest That Hedge Funds Need Greater Transparency*, L.A. TIMES, Apr. 16, 2008, at C4.

[13] *See, e.g.*, *id.*

[14] *Investing- Cultivating Chinese Hedges*, ASIAMONEY, Oct. 9, 2006, http://www.asiamoney.com/Article/2056119/Search/Results/INVESTING-Cultivating-Chinese-hedges.html?Keywords=hedge+fund+2006&OrderType=2&PageMove=6 (last visited Nov. 7, 2008).

the collapse of an entire financial system, and the idea that the hedge fund industry, which is supposed to exclude the common layperson investor, is now catering to that very subset of the investing population.[15] A concern raised less frequently, but one which critics claim is equally disconcerting, is the belief that hedge fund fraud is a widespread problem.[16] Critics reason that these concerns warrant stripping hedge funds of their exempt status and requiring them to comply with the registration and disclosure requirements of the Securities and Exchange Commission (SEC).[17]

This article argues that these concerns fail to justify such a move because the current system provides ample protections while preserving the unique benefits the hedge fund industry has to offer. To the extent that policymakers nonetheless find the critics compelling, this article further contends that there are alternative strategies which would be less drastic and more effective at achieving their aims. Accordingly, Part II of this article defines hedge funds while Part III outlines the current regulatory model and the legal status of such funds. Part IV details and evaluates the three concerns outlined above, and Part V suggests four alternatives to subjecting hedge funds to mandatory SEC registration and disclosure requirements. The article concludes by warning that while some reform seems likely, policymakers should be careful not to overreact by enacting regulations which effectively scrap the current system in favor of a model which threatens to abolish the hedge fund industry altogether.

I. WHAT ARE HEDGE FUNDS?

Despite a storied sixty-year history, hedge funds have proven difficult, if not impossible, to define.[18] Notably, hedge funds are not defined anywhere in the federal securities laws.[19] Commentators have broadly defined them as "any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public."[20] The SEC, adopting a similarly vague definition, has referred to them as "entit[ies] that hold[] a pool of securities and perhaps other assets, whose interests are not sold in a registered public offering and which [are] not registered [with the SEC]."[21] Yet,

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[15] Alfred C. Tierney, *The SEC's Rule 206(4)-8: Two Steps Back And One Step Forward*, 44 CAL. W. L. REV. 589, 597-603 (2008); Alexander R. Roche, *The Regulator Strikes Back: A Look at the SEC's Most Recent Attempt to Regulate Hedge Funds and What it Missed*, 33 U. DAYTON L. REV. 145, 152-53 (2007).

[16] Tierney, *supra* note 15, at 599-600.

[17] *See, e.g.*, Franklin R. Edwards, Hedge Funds and Investor Protection Regulation (May 16, 2006) (unpublished conference paper), *available at* http://www.frbatlanta.org/news/conferen/06fmc/06fmc_edwards.pdf.

[18] Sargon Daniel, *Hedge Fund Registration: Yesterday's Regulatory Schemes for Today's Investment Vehicles*, 2007 COLUM. BUS. L. REV. 247, 251 (2007).

[19] Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975, 981 (2006).

[20] Tierney, *supra* note 15, at 593-94.

[21] U.S. Sec. & Exch. Comm'n, Staff Report to the United States Securities and Exchange Commission: Implications of the Growth of Hedge Funds, 9 n.27 (Sept. 2003), *available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf, (last visited Mar. 11, 2009) [hereinafter *Staff*

perhaps the most useful and precise means of defining hedge funds is by noting their basic universal characteristics.[22]

As nearly all the "formal" definitions recognize, hedge funds are private pools of capital representing investments from wealthy individuals and financial investment vehicles.[23] The funds' managers utilize a variety of investment strategies including program trading, swaps, derivatives, and arbitrage,[24] and leverage funds' assets to maximize returns.[25] In return for their services, managers collect hefty commission fees, typically amounting to around twenty percent of a fund's total profits.[26]

Hedge funds are perhaps most renown for being subject to limited government regulation.[27] The only regulations directly applicable to hedge funds are the federal securities laws' various antifraud provisions.[28] This general lack of regulation, combined with the industry's expansive nature over the past two decades, has left some feeling uneasy about the current regulatory philosophy.[29] It is a negative perception which seems to stem from the notion that hedge funds are the product of crafty legal maneuverings which exploit shortcomings in the law.[30] The fact of the matter is, however, that federal securities laws were never designed to regulate hedge funds or their managers. It is an industry the law intentionally left untouched.

II. THE CURRENT REGULATORY MODEL AND LEGAL STATUS OF HEDGE FUNDS

Federal securities laws are premised on a philosophy of disclosure.[31] After the stock market crash of 1929, there was no denying the fact that the financial markets needed regulation.[32] Congress settled on a model which leaves the decision regarding the soundness of an investment to the investors themselves.[33]

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[22] *See* Daniel, *supra* note 18, at 251 (noting that the easiest means of defining hedge funds is by describing their universal characteristics).

[23] Tierney, *supra* note 15, at 594.

[24] Edwards, *supra* note 17, at 40.

[25] Jennifer Ralph Oppold, *The Changing Landscape of Hedge Fund Regulation: Current Concerns and a Principal-Based Approach*, 10 U. PA. J. BUS. & EMP. L. 833, 839 (2008).

[26] Kathleen E. Lange, *The New Antifraud Rule: Is SEC enforcement the most efficient way to protect investors from hedge fund fraud?*, 77 FORDHAM L. REV. 851, 858 (2008).

[27] *See* Tierney, *supra* note 15, at 594 (stating that the most important characteristic of hedge funds is the fact that they avoid regulation).

[28] *See* Houman B. Shadab, *The Challenge of Hedge Fund Regulation*, 36 SECURITIES & INVESTMENT (2007), *available at* http://www.cato.org/pubs/regulation/regv30n1/v30n1-1.pdf (noting that federal securities laws prohibit hedge funds from fraud and insider trading).

[29] *See, e.g.*, Tierney, *supra* note 15, at 596-98.

[30] *See id.* (stating that hedge funds take advantage of exemptions in federal securities laws).

[31] *See* Jeffrey D. Chadwick, *Proving Preemption by Proving Exemption: The Quandary of the National Securities Market Improvement Act*, 43 U. RICH. L. REV. 765, 767 (2009).

[32] Elizabeth Keller & Gregory A. Gehlmann, *Introductory Comment: A Historical Introduction to the Securities Act of 1933 and the Securities Exchange Act of 1934*, 49 OHIO ST. L.J. 329, 330, 338 (1988). *See also* Chadwick, *supra* note 32, at 767 ("Amidst the Great Depression, Franklin Roosevelt recognized the need for federal regulation and implored Congress to enact the Securities Act of 1933").

[33] *See* Chadwick, *supra*, note 31, at 767.

The government's role in this regulatory scheme is restricted to collecting and making available certain fundamental information about public securities—such as financial statements, business strategies, and details relating to products or services[34]—as well as monitoring issuers of those securities to prevent fraud.[35]

Federal securities laws, however, were never intended to regulate every type of investment.[36] Quite the opposite, they were designed for the specific purpose of protecting the common layperson investor, unfamiliar with the complexities of the financial markets (unsophisticated investors).[37] Prior to the passage of the first securities laws, unsophisticated investors were at a severe informational disadvantage.[38] Whereas professional advisors, investment companies, and other professional players in the financial markets (sophisticated investors) were capable of obtaining pertinent investment information for themselves,[39] unsophisticated investors were forced to rely on whatever representations the companies offered and were without any practical means of verification.[40] The theory behind the federal securities laws, therefore, was to level the playing field through a system of mandatory disclosure.[41]

Serving as the framework for a regulatory regime which has span the better part of eight decades, the first four Acts ever passed relating to securities regulation reflect this philosophy of protecting unsophisticated investors through disclosure. Each of these Acts also carves out specific exemptions which permit sophisticated investors and private issuers to trade unencumbered by government restrictions. Hedge funds are setup so as to ensure that they satisfy each of these exemptions and accordingly fall outside the purview of SEC regulations. The four Acts consist of the Securities Act of 1933 (Securities Act),[42] the Securities Exchange Act of 1934 (Exchange Act),[43] the Investment Company Act of 1940 (Investment Company Act),[44] and the Investment Advisers Act of 1940 (Advisers Act).[45]

A. The Securities Act Exemption

The Securities Act was intended to bring truth into the securities markets by

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[34] Sec. & Exch. Comm'n, The Law That Governs the Securities Industry, http://www.sec.gov/about/laws.shtml (last visited Mar. 29, 2008); Hannah Glover, *Most Hedge Funds Remain Registered*, Financial Planning, Jan. 19, 2007, http://www.financial-planning.com/asset/article/527952/most-hedge-funds-remain-registered.html.

[35] *See* Chadwick, *supra* note 31, at 767.

[36] *See id.*

[37] *See id.*

[38] *See* Thomas Lee Hazen, *The Law of Securities Regulation* § 1.2[2] (4th ed. 2002) (noting. that there were a significant number of fraudulently floated securities that contributed to the stock market crash of 1929).

[39] 17 C.F.R. § 230.506(b)(2)(ii).

[40] *See* Hazen, *supra* note 38.

[41] *Id.*

[42] 15 U.S.C. § 77a.

[43] *Id.* at § 78a.

[44] *Id.* at § 80a: 1-64.

[45] *Id.* at §80b: 1-21.

requiring that publicly offered securities be registered with the SEC.[46] The process was designed to enable the investor, rather than the government, to make informed judgments about the soundness of purchasing a particular security.[47] The Act requires disclosure of company property, management, and financial statements certified by independent accountants.[48] It also prohibits deceit, misrepresentation, and other fraud in the sale of securities.[49]

Pursuant to section 4(2) of the Act, securities made available only in private offerings are not subject to these registration and disclosure rules.[50] That section states that "transactions by an issuer not involving any public offering" are exempt from the regulation.[51] The U.S. Supreme Court addressed this private-offering exemption in *SEC v. Ralston Purina, Co.*, holding that in order for an offering to fall within the exemption, the recipients of the offer must "be able to fend for themselves."[52]

The case involved a corporation offering to sell its common stock to its employees without complying with the Security Act's registration requirement.[53] The SEC claimed that this amounted to a public offering which required registration.[54] The company conceded that had the offering been made to "all of its employees," the SEC would have been correct, but because it only offered "key employees" the opportunity to purchase its stock, the offering was private and therefore exempt from the Act's registration requirement.[55] The Court agreed.

In siding with the company, the Court explained that the Security Act was designed to protect the general public by "promoting full disclosure of information thought necessary to informed investment decisions."[56] Notably, the Court's decision specifically held that the Act was not intended to apply to parties sophisticated enough to partake in private offerings.[57] Those parties, the Court said, are capable of protecting themselves.[58]

After *Ralston*, the SEC promulgated Rule 506 of Regulation D to solidify the private offering exemption.[59] Rule 506 provides a safe harbor to issuers who meet the conditions of section 4(2), provided the offering is not publicly advertised and has thirty-five or fewer purchasers.[60] Hedge funds are availed of this safe harbor

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[46] U.S. Sec. & Exch. Comm'n, The Law That Governs the Securities Industry, http://www.sec.gov/about/laws.shtml (last visited Mar. 29, 2008).

[47] *Id.*

[48] *Id.*

[49] *Id.*

[50] 15 U.S.C. § 77d(2).

[51] *Id.*

[52] 346 U.S. 119, 125 (1953).

[53] SEC v. Ralston Purina, Co., 346 U.S. 119, 120 (1953).

[54] *Id.*

[55] *Id.* at 121-22.

[56] *Id.* at 125.

[57] *Id.*

[58] *Ralston*, 346 U.S. at 125.

[59] *See* 17 C.F.R. § 230.506 (2008).

[60] *See id.*

because they only make interest in their funds available at private offerings to "accredited investors."[61] Accredited investors, as defined by the Securities Act, are individuals with a net worth greater than $1 million or annual incomes greater than $200,000,[62] and institutional investors with more than $5 million in assets.[63] The accredited investor definition is important because under Rule 506, an issuer selling its securities to accredited investors is not subject to the limit of thirty-five purchasers.[64] They may sell to an unlimited number of accredited investors.[65] Thus, because hedge funds only offer their securities privately to individuals and entities the law deems capable of protecting themselves, they are exempt from the Securities Act's registration requirements.[66]

B. The Exchange Act Exemption

Whereas the Securities Act requires registration of new securities, the Exchange Act was designed to curb market speculation and manipulation by regulating the resale of securities.[67] The Exchange Act's two most notable feats were its regulation of brokers and dealers,[68] and its requirement that issuers with more than 500 owners[69] and over $10 million in assets register with the SEC.[70] In an effort to expand the SEC's regulatory authority, the Act broadly defined brokers and dealers. Under the Act, a broker is defined as "any person engaged in the business of effecting transactions in securities for the accounts of others."[71] It defines a dealer as "any person engaged in the business of buying and selling securities for such person's own account through a broker."[72]

Hedge funds could seemingly be classified as either brokers or dealers under the Act and thus be required to register. But according to the SEC, there is an important distinction between broker-dealers and traders. Traders are entities which trade for investment purposes as part of their regular business rather than acting as paid intermediaries in the securities markets.[73] The SEC recognizes hedge funds as traders, and accordingly, they are exempt from the broker-dealer

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[61] *Staff Report*, *supra* note 21, at 14-15.

[62] 17 C.F.R. § 230.501(a) (2008). To qualify as an accredited investor under the annual-income standard, the investor must have had an annual income in excess of $200,000 for the last two years and must have a reasonable expectation that same level of income in the current year. *Id.* at §230.501(a)(6). If the investor is married, he or she must have a joint income that is in excess of $300,000. *Id.*

[63] *Id.* at §230.51(a)(1)(A).

[64] 17 C.F.R. § 230.506 (2008).

[65] *Id.*

[66] There exists some debate as to whether Rule 506's use of wealth as a proxy for financial sophistication is a sound regulatory strategy. *See, e.g.*, Helen Parry, *Hedge Funds, Hot Markets and the High Net Worth Investor: A Case for Greater Protection?*, 21 NW. J. INT'L L. & BUS. 703, 718-19 (2001) (arguing that even millionaires need to be protected from the dangers of risky investments).

[67] *See* Keller & Gehlmann, *supra* note 32, at 348.

[68] 15 U.S.C. §78c(a)(4).

[69] *Id.* at §78c(g) (2006).

[70] 17 C.F.R. § 240.12g-1 (2007).

[71] 15 U.S.C. §78c(a)(4).

[72] *Id.*

[73] *Staff Report*, *supra* note 21, at 18.

registration requirement.[74]

The other relevant provision of the Exchange Act relates to section 12(g). That section requires securities with 500 owners or more and over $10 million in assets to register with the SEC.[75] Hedge funds, however, typically have fewer than 500 owners and are thus exempt from this registration requirement.[76] Because they are exempt from section 12(g), hedge funds are generally exempt from the reporting requirements of beneficial owners[77] contained in sections 13 and 16 of the Act as well.[78] But there are certain instances in which hedge funds are required to report their ownership of other equity securities registered under section 12(g). Hedge funds, for instance, must disclose their holdings to the SEC if they acquire greater than a five percent interest in a class of equity securities[79] or if they hold accounts totaling more than $100 million.[80]

C. The Company Act Exemption

The Company Act was designed to prevent investment companies from taking advantage of unsophisticated investors by requiring that such entities register with the SEC.[81] The registration process requires disclosure of the investment company's structure, operations, financial condition, and investment policies when its shares are initially offered to the public, and thereafter on a regular basis.[82] Under the Act, an investment company is defined as an issuer that "is or holds itself out as being engaged primarily . . . in the business of investing, reinvesting, or trading in securities."[83] Although hedge funds fit within this general definition, the Act goes on to provide two statutory exemptions.

Section 3(c)(1) excludes any investment company that has 100 or fewer beneficial owners of its securities and that does not intend to make those securities available in a public offering.[84] Each investor is counted toward the 100-investor limit, regardless of whether the investor is an individual or an investment entity.[85] If a hedge fund counts an investment entity as an investor and that entity holds ten

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[74] *Id.*

[75] 15 U.S.C. § 78l(g)(1) (2004).

[76] *Staff Report*, *supra* note 21, at 18-19.

[77] Beneficial ownership refers to an individual or entity that enjoys the benefits of ownership even though title is in another name. 17 C.F.R. 240.13d-3.

[78] *See* 15 U.S.C. §§ 78m and 78p (2002).

[79] An equity security is "[a]n instrument that signifies an ownership position (called equity) in a corporation, and represents a claim on its proportional share in the corporation's assets and profits. InvestorWords.com, Equity Security, http://www.investorwords.com/1737/equity_security.html (last visited Mar. 29, 2008).

[80] 15 U.S. C. § 78m (2002).

[81] *See Staff Report*, *supra* note 21, at 127. The Act also included specific protections against self-dealing, conflicts of interest, misappropriation of funds, and overreaching fees. *Id.*

[82] Securities Industry & Financial Markets Association—Investment Company Act of 1940 [hereinafter "*Primer*"], http://www.sifma.org/legislative/invstmt_comp_act_of_1940.html (last visited Mar. 29, 2008).

[83] 15 U.S.C. § 80a-3(a)(1)(A) (2000).

[84] *Id.* at §80a-3(b).

[85] *Staff Report*, *supra* note 21, at 13.

percent or more of the fund's outstanding voting shares, then the fund must "look through" the entity and count the investors therein as part of its 100-investor limit.[86]

The second exclusion derives from section 3(c)(7) of the Act. According to that section, investment companies with outstanding securities owned exclusively by qualified purchasers are exempted from the Act's disclosure requirements.[87] The Act defines "qualified purchasers" as (1) individuals who own $5 million in investment assets or more, (2) family-owned companies that own $5 million in investment assets or more, (3) trusts not formed for the purpose of investing in a section 3(c)(7) fund whose trustees are qualified purchasers, and (4) individuals who manage their own accounts and have $25 million or more in investment assets.[88] Although the Company Act permits hedge funds to have an unlimited number of qualified-purchaser investors, in order to comply with the Exchange Act exemption, they limit that number to 499.[89] The Company Act, moreover, excludes hedge funds from its registration and disclosure requirements because it limits potential hedge fund investors to a small number of extremely wealthy individuals who are either sophisticated in such investment ventures or who will not be devastated by the potential losses.

D. The Advisers Act Exemption

The last of the four foundational Acts, the Advisers Act, was promulgated in tandem with the Company Act.[90] Like its regulatory sibling, the Advisers Act was designed to guard against industry professionals abusing unsophisticated investors.[91] It requires that investment advisers register with the SEC and disclose their records, advisory contracts, advertisements, clients' funds and assets, and proxy voting rights.[92] Section 202(a)(11) defines an investment adviser as

> any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or

[86] *Id.* As a practical matter, this "look through" concept is of little consequence as it may easily be circumvented by creating a Russian-doll scheme. Dusting G. Hall, *The Elephant in the Room: Dangers of Hedge Funds In Our Financial Markets*, 60 FLA. L. REV. 183, n. 62 (2008). In such a scheme, the investing entity that is going to hold more than ten percent of the outstanding voting shares creates another entity to hold 100 percent of its interest in the fund. *Id.* The original investment entity is the sole owner of the actual investment entity and thus the original entity's investors retain an interest in the hedge fund. *Id.* However, when the hedge fund looks through the investing entity, rather than seeing all the investors in the original entity, it only sees the original entity. *Id.* Accordingly, it still only counts as one investor. *Id.*

[87] 15 U.S.C. § 80a-3(c)(7) (2004).

[88] *Id.* at a-2(a)(51)(A).

[89] *See* Willa E. Gibson, *Is Hedge Fund Regulation Necessary?*, 73 TEMP. L. REV. 681, 694-95 (2000) (noting that most hedge funds have fewer than 100 investors but that hedge fund managers must pay close attention to the number of investors to continue to qualify for § 3(c)(1)'s exclusion).

[90] *Primer*, *supra* note 82.

[91] *See Staff Report supra* note 21, at 20-21.

[92] SIFMA.org, Investment Advisers Act of 1940, http://www.sifma.org/legislative/invstmt_adv_act_of_1940.html (last visited Apr. 11, 2009).

reports concerning securities . . . [93]

Put simply, an investment adviser is someone who is paid to provide advice about purchasing or selling securities. Although virtually every hedge fund manager meets this definition,[94] they are exempt from the Act's registration and disclosure requirements pursuant to section 203(b)(3). That section states that advisers who have had fewer than fifteen clients in the past twelve months, do not represent themselves to the investing public as an investment adviser,[95] and do not advise a registered company, fall outside the purview of the Act's regulatory intent.[96] However, hedge fund managers are subject to the Act's extensive antifraud provisions which require compliance from everyone who satisfies the statute's investment adviser definition, regardless of whether or not they are required to register with the SEC.[97]

III. CONCERNS ABOUT HEDGE FUNDS

The past nineteen years have been a period of tremendous growth for the hedge fund industry. In 1990, a mere 300 funds managed approximately $39 billion.[98] Those numbers swelled to roughly 6,000 funds managing over $550 billion in 2001,[99] and by 2007, there were more than 9,000 funds responsible for investments totaling around $1.4 trillion.[100]

This growth has prompted some to question the soundness of permitting hedge funds to continue taking advantage of the various registration and disclosure exemptions set forth in the federal securities laws.[101] Indeed many of these critics have begun calling for new regulations which would render hedge funds and their managers subject to SEC oversight.[102] Effectively an expansion of the existing regulatory scheme, under this proposed model, "the SEC will want to know what the [hedge fund] advisor's process is, who is responsible for what operations and that the entire [investment] valuation process is documented."[103] Although many have expressed concerns about the consequences of such a system—the most drastic of which warning that it would effectively bring an end to hedge fund

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[93] 15 U.S.C. § 80b-2(a)(11) (2006).

[94] *Staff Report*, *supra* note 21, at 20.

[95] The SEC has said that a party holds itself out to the public as an investment adviser if it maintains a listing as an investment adviser in a telephone or business directory, expresses a willingness to accept new clients, or using letterhead indicating any investment-adviser activities. Gibson, *supra* note 89, at 698.

[96] 15 U.S.C. § 80b-3(b)(3) (2006).

[97] SIFMA.org, *supra* note 92.

[98] Erik J. Greupner, Comment, *Hedge Funds Are Headed Down-Market: A Call for Increased Regulation?*, 40 SAN DIEGO L. REV. 1555, 1561 (2003).

[99] *Id.*

[100] Vora & Gongloff, *supra* note 10.

[101] *See* Edwards, *supra* note 17 (noting that the SEC sponsored investigations and studies of hedge funds in 1969, 1972, and 1999).

[102] *See, e.g.*, *Staff Report*, *supra* note 21.

[103] Glover, *supra* note 34.

industry and the myriad benefits it provides[104]—critics contend that the risks hedge funds currently present warrants extensive government supervision.[105] Regulation will undoubtedly provide those skeptical of the hedge fund industry with a sense of security, but whether there exists valid pretext for such a move, and whether it would provide any real protection, are two important, yet relatively unexplored, issues.

A. Systemic Risk

Systemic risk, one of the two primary concerns cited by critics, relates to the safety and soundness of financial markets.[106] It has been defined as

> the potential for a modest economic shock to induce substantial volatility in asset prices, significant reductions in corporate liquidity, potential bankruptcies and efficiency losses. A key feature in the propagation of such a systemic shock is acute uncertainty regarding an institution's ability to satisfy its immediate payment obligations and a simultaneous inability of counterparties to hedge such risk.[107]

In simpler terms, systemic risk refers to financial markets becoming destabilized when an event causes a sudden decline in the prices of certain assets and a simultaneous tightening of credit by lending institutions.[108] As panicked lenders call loans due, invested entities are forced to liquidate their holdings in order to raise the necessary capital to satisfy their loan agreements.[109] Institutions originally unaffected by the market shift are suddenly sucked in, their assets becoming devalued due to the credit crunch, and overall market liquidity begins to dissolve.[110] It is a domino effect which permeates the entire financial system, making it difficult for businesses to comply with their lenders demands, and forcing many into bankruptcy.[111] The end result is the entire financial system being brought to its knees.

The reason some have claimed that hedge funds pose a systemic risk is because of the risky nature of their investment strategies combined with the extent to which they are invested in the financial markets.[112] The notion is that a fund may become drastically over-invested in one aspect of the market, fail, and initiate the chain of events which ultimately causes a systemic collapse. This concern is

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[104] *See* Shadab, *supra* note 28 (stating that academics, industry professionals, and regulatory authorities overwhelmingly agree that hedge fund provide benefits because they are relatively unregulated).

[105] *See, e.g.*, Tierney, *supra* note 15, at 603.

[106] *See* Paredes, *supra* note 18, at 983.

[107] Paul Kupiec & David Nickerson, *Assessing Systemic Risk Exposure from Banks and GSEs Under Alternative Approaches to Capital Regulation*, 48 J. REAL EST. FIN. & ECON. 123, 123 (2004), *available at* http://www.landecon.cam.ac.uk/research/reuag/maastricht/pdf/MaasCamNickKup02.pdf.

[108] Thomas C. Pearson & Julia Lin Pearson, *Protecting Global Financial Market Stability and Integrity: Strengthening SEC Regulation of Hedge Funds*, 33 N.C. J. INT'L L. & COM. REG. 1, 32 (2007).

[109] *Id.*

[110] *Id.*

[111] *Id.*

[112] *See, e.g.*, Pearson & Pearson, *supra* note 108.

magnified by the fact that hedge funds use leverage.[113] Designed as a means of maximizing returns,[114] when hedge funds fail, that leveraging strategy works in an inverse direction, producing maximum losses.[115] Banks and other financial institutions, having miscalculated their risk or exposure when extending credit to such funds, may fail next and thereby set the stage for a credit crisis and subsequent systemic failure.[116]

Critics, almost uniformly, are quick to cite the infamous 1998 downfall of Long-Term Capital Management (LTCM) as evidence of the devastation a failed hedge fund can wreak on broader financial systems.[117] For example, as financial journalist Roger Lowenstein commented two years after the incident, "[a]lmost all of the country's major financial institutions were put at risk due to their credit exposure to [LTCM]. . ."[118] In the end, the LTCM debacle did not cause any systemic failure, a result many attribute to the government's intervention.[119] A closer inspection, however, reveals that it is unlikely the situation created any impending systemic threat in the first place.

1. The LTCM Debacle

LTCM was a highly regarded hedge fund founded by two Nobel Prize-winning economists in 1994.[120] Its primary trading strategy was based on the fund's prediction that the global risk premium on debt would decrease, which would in turn cause the price of more risky debt to increase while the price of less risky debt, such as government securities, decreased.[121] Unexpectedly, however, in the midst of an ongoing financial crisis in Asia, Russia devalued its ruble and imposed a debt moratorium.[122] This prompted a worldwide increase in risk premium as investors flocked to less risky debt, the exact opposite of what LTCM had envisaged.[123] As a result, the fund lost upwards of $4.4 billion dollars.[124]

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[113] *See* Paul M. Jonna, *In Search Of Market Discipline: The Case For Indirect Hedge Fund Regulation*, 45 San Diego L. Rev. 989, 996 (claiming that hedge funds are known for their abusive use of leverage).

[114] THOMAS SCHNEEWEIS, HOSSEIN KAZEMI & VASSILIS KARAVAS, LEVERAGE IMPACTS ON HEDGE FUND RISK AND RETURN PERFORMANCE 1 (Isenberg Sch. Mgmt., U. Mass. 2004), *available at* http://www.lyracapital.com/documents/Leverage-final.pdf (last visited Oct. 10, 2009).

[115] *See* Tierney, *supra* note 15, at 603 (explaining that the crux of the LTCM problem was the extent to which it was leveraged).

[116] *See id.* ("major banks and other creditors who enabled LTCM to build up its leveraged positions were concerned about the effect of a default on their operations.") (quoting Melissa Antoszewski, *Las Vegas Style Investing: In the Absence of Regulation, Risky Hedge Fund Bets Can Win Big and Lose Even More*, 8 TRANSACTIONS TENN. J. BUS. L. 381, 407 (2007)).

[117] *Goldstein v. SEC*, 451 F.3d 873, 877 (D.C. Cir. 2006) (citing ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT (Random House 2000)).

[118] *Id.*

[119] *See* Tierney, *supra* note 15, at 603 (explaining how banks and the Federal Reserve of New York bailed out LTCM).

[120] San Jose State University, Long Term Capital Management, http://www.sjsu.edu/faculty/watkins/ltcm.htm (last visited Mar. 29, 2008).

[121] Paredes, *supra* note 18, at 984.

[122] *Id.*

[123] Paredes, *supra* note 18, at 984.

When the push for low risk debt occurred, LTCM's total portfolio was valued at \$125 billion, \$5 billion coming from investors while the remaining \$120 billion was leveraged.[125] Additionally, the fund had national derivative positions which exceeded \$1.5 trillion and an exceptionally high balance-sheet leverage ratio of 25 to 1.[126] The concern amongst regulators was that if LTCM defaulted on its obligations to its creditors and counterparties, there would be a domino effect in liquidity investments, leading to a drop in prices and the need for other entities to liquidate.[127] The Federal Reserve intervened and orchestrated a \$3.5 billion dollar bailout in order to prevent what it feared would be the destabilization of the entire U.S. financial system.[128]

The incident prompted the creation of a Presidential Working Group (PWG) which considered how to prevent such a threat in the future.[129] The PWG issued a number of recommendations, including requiring increased disclosures from public companies and financial institutions, and improving regulation of currently regulated entities to promote the development of more risk-sensitive approaches to capital adequacy.[130] The recommendation which garnered the most attention and ultimately produced new regulation, however, was the PWG's suggestion that "more frequent and meaningful information on hedge funds [] be made public."[131] It prompted a series of discussions which culminated in the SEC's promulgation of Rule 203(b)(3)-2 of the Advisers Act (the Hedge Fund Rule).[132]

2. *The Hedge Fund Rule*

The Hedge Fund Rule, passed in late 2004 in a controversial three-to-two

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[124] Shadab, *supra* note 28, at 39.

[125] Carl J. Nelson, *Hedge Fund Regulation: A Proposal To Maintain Hedge Funds' Effectiveness Without SEC Regulation*, 2 BROOK. J. CORP. FIN. & COM. L. 221, 227 (2007).

[126] Paredes, *supra* note 18, at 984.

[127] *See, e.g., id.* at n.38 (noting that William McDonough, President of the Federal Reserve Bank of New York, described the potential ramifications of an LTCM collapse this way:

> There are several ways that the problems of Long-Term Capital could have been transmitted to cause more widespread financial troubles. Had Long-Term Capital been suddenly put into default, its counterparties would have immediately "closed-out" their positions. If counterparties would have been able to close-out their positions at existing market prices, losses, if any, would have been minimal. However, if many firms had rushed to close-out hundreds of billions of dollars in transactions simultaneously, they would have been unable to liquidate collateral or establish offsetting positions at the previously existing prices. Markets would have moved sharply and losses would have been exaggerated. Several billion dollars of losses might have been experienced by some of Long-Term Capital's more than 75 counterparties.)

[128] Vora & Gongloff, *supra* note 10.

[129] *See* PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT viii (1999), http://www.treasury.gov/press/releases/reports/hedgfund.pdf [hereinafter "PWG"].

[130] *See id.*

[131] *See id.*

[132] Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333, 69 Fed. Reg. 72,054, 72,058 (Dec. 10, 2004) [hereinafter "Release No. 2333"].

vote,[133] required that hedge fund managers register with the SEC by redefining how the term "client" was interpreted under the Advisers Act.[134] Prior to the Hedge Fund Rule, managers only counted their funds as clients.[135] Because few managers oversaw more than fifteen funds, they qualified for the Act's registration and disclosure exemption.[136] The new rule, however, required managers to "look through" their funds and count each investor therein as an individual client.[137] Because hedge funds rarely have fewer than fifteen investors, the vast majority of managers no longer fit the Act's exemption.[138]

The Hedge Fund Rule was quickly challenged and unanimously overturned in *Goldstein v. SEC*.[139] The court found the rule's definition of the term "client" to be arbitrary and capricious, both because hedge fund managers do not provide direct advice to individual investors, and because to define individual investors as clients would necessarily create a conflict of interest for managers.[140] Critics, however, noting that one of the reasons the Hedge Fund Rule was passed was to force hedge funds to become more transparent and thereby enable the SEC to take preventative measures to protect the broader financial system, have condemned the court's decision as a perpetuation of the risks extant in the industry.[141] In their view, not only is there a distinct risk that hedge funds may destabilize financial markets, but the only means of protecting against such an eventuality is through direct regulation of hedge funds themselves.[142]

3. The folly of the systemic risk concern

The two Commissioners who opposed the Hedge Fund Rule noted that transparency would not have prevented the LTCM debacle.[143] They explained that although LTCM was highly leveraged and overly invested in one area, the fund was wildly popular because of its managers' prestige.[144] Its investment strategies proved enormously profitable over its first four years, declining only because global financial conditions spontaneously aligned, forming what amounted to a perfect storm for risk-based investments.[145] Because this event was unanticipated

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[133] *Id.* at 72,059.

[134] *Id.* at 72,055.

[135] 17 C.F.R. § 275.203(b)(3)-1 (2006).

[136] 15 U.S.C. § 80b-3(b)(3) (2006).

[137] Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 45,172, 45,183 (July 28, 2004). Specifically, the rule stated that for purposes of the Advisers Act, "you must count as clients the shareholders, limited partners, members, or beneficiaries ... of a private fund." 17 C.F.R. § 275.203(b)(3)-2 (2009).

[138] Sue Ann Mota, *Hedge Funds: Their Advisers Do Not Have to Register with the SEC, But More Information and Other Alternatives Are Recommended*, 67 LA. L. REV. 55, 56 (2006).

[139] 451 F.3d 873 (D.C. Cir. 2006).

[140] *Id.* at 882-84.

[141] *See* Tierney, *supra* note 15, at 618-20.

[142] *See id.* (arguing that rules enacted after the Hedge Fund Rule was struck down are inadequate).

[143] *See* Release No. 2333, *supra* note 132, at 72,090.

[144] *Id.*

[145] *See* PWG, *supra* note 129, at 10-19.

[145] *See* PWG, *supra* note 129, at 10-19.

by LTCM managers as well as virtually every other expert within the financial community, it is unlikely that additional disclosures regarding the fund's holdings or financial status would have deterred many investors.[146]

Although most suggest that the LTCM debacle and the alleged threats it posed as reason enough for regulation,[147] the fact is that LTCM offers little in the way of broader lessons regarding hedge fund regulation. In short, LTCM was an extreme case. The excessive leveraging tactics LTCM employed are a rarity in today's market. "[A]s of June 2005, one-third of hedge fund assets used no leverage at all, and over half had a 2 [to] 1 leverage ratio. . ."[148] Fixed income arbitrage hedge funds, which typically have the highest leverage ratios of all hedge funds at 4 to 1, only comprise seven percent of the industry.[149] To put these ratios in some perspective, investment banks and securities firms are typically leveraged at 20 to 1.[150]

Furthermore, had the government not intervened, it is unlikely that LTCM would have collapsed. Led by Berkshire Hathaway, a consortium of banks offered to purchase the fund's positions and continue managing it.[151] But even if LTCM had gone under and defaulted on its loans, the evidence indicates that its counterparties were capable of absorbing the losses.[152] According to a 1999 PWG report, as of September 1998, aggregate U.S. bank exposures to all hedge funds, including LTCM, through direct lending and derivative contracts only amounted to roughly one percent of their total credit exposures.[153] Although it is possible that a few banks could have disproportionately made up this one percent and that as a result certain sectors could have experienced fallout, it is unlikely that the credit industry would have been crippled to the point where systemic collapse became a real possibility.[154]

The systemic risk concern is further called into question by virtue of the fact that as of March 2003, less than four percent of all operating hedge funds were managing undercapitalized assets.[155] Capitalization is an important figure because studies have found that having adequate capital relative to the risk of underlying investments is a better predictor of hedge fund failure than is leverage.[156] In 2003, the few funds which did manage undercapitalized assets controlled a mere 1.2 percent of the industry's total assets.[157] This is perhaps helpful in explaining why studies which differentiate between funds that have failed and those that have

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[146] *See* Paredes, *supra* note 18, at 993-95.

[147] *See, e.g.*, Tierney *supra* note 15, at 602-606 (stating that the effects of LTCM increased regulators concerns and that its effects on individual investors was "obvious and disturbing, with investors losing millions to the failure[]").

[148] Shadab, *supra* note 28, at 40.

[149] *Id.*

[150] *Id.*

[151] *Id.*

[152] *Id.*

[153] Shadab, *supra* note 28, at 39.

[154] *Id.*

[155] *Id.* at 40.

[156] *Id.*

[157] *Id.*

simply stopped disclosing returns discovered that hedge fund failure rates are only around three to five percent.[158]

As a final matter, it is important to recognize that hedge funds provide financial markets with a wide array of benefits which would be lost if they were subject to SEC regulation. Hedge funds increase market efficiency and liquidity by taking speculative trading positions based upon extensive research.[159] They similarly utilize short-term trading strategies to exploit mispricings, adding to the reliability of market prices and potentially limiting the irrational appreciation of securities.[160] Furthermore, hedge funds "foster financial innovation and risk sophistication among the market participants with which they deal,"[161] distribute financial risk, and nurture the development of new ideas, products, and technology by investing in new and undercapitalized markets.[162]

Many of these benefits accrue because hedge funds are willing to "take the side of the trade that others do not want to take."[163] Constantly seeking out new investment opportunities, hedge funds invest in stocks, industries, and markets others avoid,[164] such as the second-lien loan market and corporate bankruptcies.[165] At the same time, they also participate as major creditors in the retail, automotive, and technology sectors, providing much needed capital and reducing the cost of loans.[166] As prominent New York securities lawyer, Joseph McLaughlin, concluded in his testimony before the Senate Judiciary Committee, "hedge funds' ability to deliver these benefits to the financial marketplace depends in large measure on their ability to engage in short sales and related activities."[167]

Because hedge funds fall outside the purview of federal securities regulations and are permitted to employ a unique array of investment strategies as a result,[168] they are able to make important contributions to the broader financial markets. It is also important to recognize that hedge funds provide the markets with a number of indirect benefits, most notably by positively affecting businesses. Aside from

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158 *Id.* at 39.

159 DIV. OF INV. MGMT. & OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, SEC STAFF REPORT, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS 5 (2003), http://www.sec.gov/news/studies/hedgefunds0903.pdf.[hereinafter "IMPLICATIONS OF GROWTH"].

160 Nelson, *supra* note 125, at 234-235.

161 *Id.* at 235 (quoting *Hedge Funds and Independent Analysts: How Independent Are Their Relationships?: Hearing Before the S. Comm. On the Judiciary*, 109th Cong. (2006) (statement of Joseph McLaughlin, Partner, Sidley Austin LLP, Managed Funds Association)).

162 Pearson & Pearson, *supra* note 108, at 5-6.

163 Leon M. Metzger, *Recent Market Events and the Foundation for Global Market Crises: Hedge Funds*, 4 FORDHAM FIN. SEC. & TAX L. F. 5, 15 (1999).

164 *See, e.g.*, Jim Carlton, *Biodiesel Powers Up on Financing*, WALL ST. J., Feb. 21, 2007, at B13 (noting that hedge funds have invested in the alternative fuels industry).

165 Jenny Anderson, *As Lenders, Hedge Funds Draw Insider Scrutiny*, N.Y. TIMES, Oct. 16, 2006, at A1.

166 Kit R. Roane, Hedging Their Debts, http://www.singlearticles.com/hedging-their-debts-a2016.html (last visited Mar. 29, 2008).

167 Nelson, *supra* note 125, at 235 (quoting *Hedge Funds and Independent Analysts: How Independent Are Their Relationships?: Hearing Before the S. Comm. on the Judiciary*, 109th Cong. (2006) (statement of Joseph McLaughlin, Partner, Sidley Austin LLP, Managed Funds Association)).

168 *See Goldstein v. SEC*, 451 F.3d 873, 875 (D.C. Cir. 2006) (noting that mutual funds cannot trade on margin and may not engage in short sales).

fueling innovation by participating in the venture capital and startup markets,[169] hedge funds often become activist shareholders in larger corporations.[170] They assume large ownership positions and effect change by proposing new strategies, negotiating with management, initiating proxy battles, or even taking over control of the company.[171] In several instances, hedge funds have removed underperforming CEOs,[172] forced companies to streamline their operations,[173] and returned corporate revenues to the shareholders as dividends.[174]

Although there have been a few rogue hedge funds like LTCM, on the whole, they have proven to be relatively sound investments that provide important benefits to the overall economic process. As Alan Greenspan, former Chairman of the Federal Reserve Bank, stated in his testimony before the House Committee on Banking and Financial Services:

> [M]any of the things which [hedge funds] do . . . tend to refine the pricing system in the United States and elsewhere. And it is that really exceptionally and increasingly sophisticated pricing system which is one of the reasons why the use of capital in this country is so efficient . . . there is an economic value here which we should not merely dismiss . . . I do think it is important to remember that [hedge funds] . . . by what they do, they do make a contribution to this country.[175]

B. Retailization

The other major concern regarding hedge funds is retailization.[176] "Retailization" was the term coined to explain the increased exposure of unsophisticated investors to the hedge fund industry.[177] In recent years, retailization concerns have escalated, primarily because of the proliferation of

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[169] Robert W. Helm, *Creating, Managing, and Distributing Offshore Investment Products: A Legal Perspective, in* NUTS & BOLTS OF FINANCIAL PRODUCTS 2002 UNDERSTANDING THE EVOLVING WORLD OF CAPITAL MARKET & INVESTMENT MANAGEMENT PRODUCTS 231, 269-70 (Practising Law Institute 2002).

[170] Pearson & Pearson, *supra* note 108, at 6.

[171] *See* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1029 (2007).

[172] Hedge funds pressured the removal of Deutsche Borse, CEO Werner Seifert. Heather Connon, *Hedge Funds Are the New Activists*, THE OBSERVER, Mar. 4, 2007, at 4; Alan Murray, *Heinz Is Better Served With Peltz Outside of the Board Room*, WALL ST. J., Aug. 9, 2006, at A2.

[173] Hedge funds have significantly impacted the restructuring of the auto parts industry. Jeffrey McCracken et al., *For Car Industry, Sum of the Parts May Be Lifeline: Hedge Funds, Buyout Companies Line Up to Pour Billions of Dollars into Slimmed-Down Suppliers*, WALL ST. J., Oct. 26, 2006, at C1.

[174] Hedge funds, as bond-holders, are demanding immediate payout of debt when a technicality arises for default. *See* Peter Lattman & Karen Richardson, *Hedge Funds Play Hardball with Firms Filing Late Financials*, WALL ST. J., Aug. 29, 2006, at A1. For example, when a public company does not timely file its financial statements with the SEC, some hedge funds then extract substantial fees from the company or higher interest rates from the company's bonds in exchange for an extension of their default deadline. *Id.*

[175] *Private-Sector Refinancing of the Large Hedge Fund, Long-Term Capital Management: Hearing Before the H. Comm. On Banking & Financial Serv.*, 105th Cong. (1998) (statement of Alan Greenspan, Chairman, Board of Governors of the Fed. Reserve),

[176] Lange, *supra* note 26, at 855.

[177] Edwards, *supra* note 17, at 15-16.

FOFs and the increased participation of institutional investors in the hedge fund industry.[178] These intermediary investment vehicles have begun to blur the line separating sophisticated and unsophisticated investors by sinking an increasing amount of unsophisticated investor wealth into hedge funds.[179] In so doing, these investment vehicles grant unsophisticated investors access to investment opportunities previously foreclosed to them by providing a means of hurdling the industry's traditional exclusionary barriers, most notably, its wealth requirements.[180] The situation has prompted some observers to contend that hedge funds now cater to those whom the securities laws were designed to protect, and should thus render them subject to SEC regulation.[181]

1. Fund of Funds

FOFs are mutual funds that distribute investors' monies over a diversified pool of hedge funds in order to minimize risk.[182] Typically assembled by banks and money management firms,[183] most FOFs are registered with the SEC pursuant to the Company Act.[184] They are structured as limited partnerships and offer investors a number of advantages, including due diligence and manager diversity.[185]

FOFs present retailization concerns because they have relatively low minimum investment requirements.[186] Hedge funds have always relied upon high investment minimums to exclude unsophisticated investors from the industry.[187] These minimums are generally set at around $1 million per investor, but in some cases may reach as high as $50 million.[188] Like other mutual funds, FOFs pool

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[178] *Id.* at 17.

[179] M.P. Dunleavey, *Does "Hedge Fund" Mean Anything Anymore?*, N.Y. TIMES, Oct. 9, 2005 § 3, at 26.

[180] *Id.*

[181] *See Id.*

[182] Thierry Olivier Desmet, *Understanding Hedge Fund Adviser Regulation*, 4 HASTINGS BUS. L.J. 1, 3-4 (2008). Generally, FOFs invest in between five and fifty different hedge funds. *Id.* at 4.

[183] Geraldine Fabrikant, *Hedge Funds Work for Yale, But Will They Work for You?*, N.Y. TIMES, Nov. 27, 2005, at B5.

[184] Edwards, *supra* note 17, at 18-19. Certain FOFs, referred to as unregistered FOFs, are not registered with the SEC. *Id.* at 18. They are, in effect, hedge funds qualifying for the same federal securities exemptions and prohibiting unsophisticated investors from investing in their securities. *Id.* Consequently, they do not raise retailization concerns. *Id.*

[185] Paredes, *supra* note 18, at 992-93. FOFs do, however, have some drawbacks. One is the double layer of fees that investors are charged. Andrew Steward, *The Bank of New York and Casey, Quirk & Associates Thought Leadership Series October 2006 White Paper Institutional Demand For Hedge Funds 2: A Global Perspective*, 1622 PRACTISING LAW INSTITUTE, CORPORATE LAW AND PRACTICE COURSE HANDBOOK SERIES 355, 369-70 (2007). In addition to paying the FOF's fee, an investor must also pay the underlying hedge funds' fees as well. *Id.* Another disadvantage is transparency. *Id.* Investing in a hedge fund is effectively an investment in the fund's manager. *Id.* It is that manager who selects how, when, and where to allocate the fund's assets. *Id.* FOF investors do not select the hedge funds in which their monies will be invested and thus must rely on the FOF's manager's judgment in selecting a hedge fund manager. *Id.*

[186] IMPLICATIONS OF GROWTH, *supra* note 159, at 69.

[187] *See* Dunleavey, *supra* note 179.

[188] *Id.*

investor capital, allowing them to offer unsophisticated investors an end around hedge funds' minimum investment requirements.[189] Instead of an individual investor being required to satisfy the entire minimum investment amount in order to invest in a hedge fund, FOFs only require an investor to foot a fraction of that amount. In some instances, this means that investors are required to put up as little as $25,000 each.[190] By aggregating these smaller investment sums, FOFs provide investors of relatively modest means with the ability to participate in an industry designed only for sophisticated players.

2. *Institutional Investors*

Institutional investors have had a similar effect. They are entities, such as mutual funds, pension funds, and endowments, with substantial amounts of capital to invest.[191] Like FOFs, institutional investors raise the issue of whether their investors understand the potential risks associated with investing in hedge funds.[192] However, they also present an additional retailization concern relating to the principal-agent relationship between investor and manager.[193] These concerns are especially pronounced with respect to pension plans, the institutional investors that have received the brunt of the criticism for their increased hedge fund investments.[194]

The interests of institutional investor managers often conflict with those of the investors in that entity. An agency relationship is created whenever unsophisticated investors delegate their investment decision-making authority to professional managers.[195] The problem in the institutional investor context is that managers earn a percentage of the returns realized from their investments.[196] This is a traditional arrangement between investor and manager and was ironically designed to align the two parties' interests.[197] In reality, however, institutional investors such as pension funds tend to cater to investors seeking steady and secure long-term gains.[198] This produces a misalignment of interests between investors and managers because managers may be willing to assume more risk than their investors in order to increase their own compensation.[199]

Although they are not the cause, hedge funds are manifestations of this principal-agent conflict. They are attractive investment opportunities for the less

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[189] IMPLICATIONS OF GROWTH, *supra* note 159, at 69.

[190] *Id.*

[191] InvestorWords.com, Institutional Investor, http://www.investorwords.com/2504/institutional_investor.html (last visited Dec. 29, 2008).

[192] Edwards, *supra* note 17, at 23.

[193] *Id.*

[194] *Id.*

[195] *Id.*

[196] Lange, *supra* note 26, at 858.

[197] *Id.*

[198] *See* Tierney, *supra* note 15, at 602 (stating that the beneficiaries of institutional investors may not willingly choose to assume the risks inherent in investing with hedge funds); *see also* Edwards, *supra* note 17, at 23.

[199] Tierney, *supra* note 15, at 602.

risk adverse managers because of their potential to yield high risk-adjusted returns.[200] In down markets, when other assets are depressed and providing minimal, if not negative, returns, hedge funds become even more enticing an opportunity as managers find it easier to rationalize a risky investment decision.[201] These conflicting interests, moreover, have caused some to worry that unsophisticated investors may either become unwittingly entangled in the hedge fund industry or become more exposed to its risks than they anticipated.[202]

3. Retailization: a cause for concern or a benefit to investors?

On July 25, 2006, then chairman of the SEC, Christopher Cox, testified before the U.S. Senate Committee on Banking, Housing and Urban Affairs that "[w]hile some refer to an alleged growing trend toward the 'retailization' of hedge funds, the [SEC's] staff [is] not aware of significant numbers of truly retail investors investing directly in hedge funds."[203] He continued by noting that retailization, which stems from intermediate investment vehicles, is a trend which is "still in its infancy."[204] Citing a recent industry report, Cox explained to the committee that

> [eighty percent] of public pension funds, and 82% of corporate funds, have little or no investment in hedge funds. Those corporate pensions that actively invest in hedge funds allocate on average only 5.3% of their assets to this entire investment class. Public pensions that actively invest in hedge funds allocate 5.1%.205

In other words, at the time of the chairman's testimony, no direct retailization was occurring in the hedge fund industry, and the indirect retailization brought about by FOFs and institutional investors was so insignificant that it was not an issue which concerned the SEC. Although the Chairman acknowledged that should retailization become more commonplace it would be alarming,[206] in light of the fact that the SEC itself found no real cause for concern a short two-and-a-half years ago, it seems difficult to accept the notion that the problem is now endemic.

Chairman Cox's relatively apathetic take on the alleged retailization problem is further explained by the current regulatory structure. Presently, unsophisticated investors' only practical means of access to the hedge fund industry is through intermediary investment vehicles.[207] These intermediary entities are operated by professional investment managers whose full time job is to evaluate and keep up

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[200] Edwards, *supra* note 17, at 24.

[201] *Id.*

[202] *Id.*

[203] Chairman Christopher Cox, U.S. Securities & Exchange Commission, Testimony Concerning the Regulation of Hedge Funds Before the U.S. Senate on Banking, Housing and Urban Affairs (July 25, 2006), *available at* http://www.sec.gov/news/testimony/2006/ts072506cc.htm.

[204] *Id.*

[205] Chairman Christopher Cox, *supra* note 203. Chairman Cox did note that nearly two-thirds of endowments invest in hedge funds, and that on average, those which do, invested eighteen percent of their capital to hedge funds. *Id.*

[206] *Id.*

[207] Edwards, *supra* note 17, at 15-16.

with hedge fund strategies and activities, and to select sound investment opportunities.[208] These managers owe their investors fiduciary duties and are required to register with the SEC pursuant to the Advisers Act.[209] The intermediary entities themselves are required to register under the Company Act, which subjects them to reporting, disclosure, liquidity, and portfolio diversification requirements, as well as to restrictions which bar them from using leveraging or short selling tactics.[210] Moreover, it is not a situation in which unsophisticated investors are being left to fend for themselves in the unregulated world of hedge funds. Quite the opposite, they are only granted permission to enter that world if escorted by a properly accredited guide from a properly accredited institution.

Benjamin Bernanke, the current Chairman of the Federal Reserve Bank, seems to agree with this assessment. In 2006, Bernanke publicly rejected the idea that regulations which require hedge funds to register with, and disclose sensitive information to, the SEC could ever be effective.[211] He noted that to inform the public of the risks associated with investing in various hedge funds, regulators would be required to gather sensitive information from all major market participants, process massive amounts of fluctuating data on at least a daily basis, and respond to high-risk exposure without causing a liquidity crisis.[212] With managers constantly changing their strategies and trading their holdings, Bernanke recognized that the hedge fund industry is expansive, fast-paced, and touches nearly every investment opportunity.[213] A regulatory model built on gathering and disseminating information in order to effectuate a useful degree of transparency, moreover, would never be able to keep up.

It is also important to note that to an extent, it is actually desirable for hedge funds to be made available to the public. They provide investors with an important risk management tool: portfolio diversification.[214] Whereas traditional investment vehicles are only equipped to achieve relative returns—returns which strive to beat various market indices[215]—hedge funds employ strategies which allow them to achieve positive, or absolute, returns.[216] This means that hedge funds aim to achieve a certain profit level regardless of overall market conditions.[217] As a result, they provide investors with money making opportunities in both up and down markets.

Furthermore, studies indicate that hedge fund investing is not uniformly more risky than is investing in mutual funds or individual stocks.[218] In fact, in

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208 Lange, *supra* note 26, at 857.

209 SIFMA.org, *supra* note 92.

210 Primer, *supra* note 82.

211 Shadab, *supra* note 28, at 41.

212 *Id.*

213 Shadab, *supra* note 28, at 41.

214 Antoszewski, *supra* note 116, at 384.

215 Nelson, *supra* note 125, at 223.

216 Alexander R. Roche, *The Regulator Strikes Back: A Look at the SEC's Most Recent Attempt to Regulate Hedge Funds and What It Missed*, 33 U. DAYTON L. REV. 145, 152 (2007).

217 *Id.*

218 Shadab, *supra* note 28, at 38.

down markets, hedge funds are typically safer.[219] Consistent with their pursuit for positive returns, most hedge funds strive to preserve investment principle by hedging against market risk.[220] Indeed, it is because hedge fund performance tends to exhibit a low correlation with traditional investments in the equity and fixed-income markets that many institutional investors use them to diversify their assets.[221] Pension plans, for instance, find hedge funds attractive precisely because they frequently produce some of the highest returns for stock investments while reducing losses in market downturns.[222]

The bottom line is that retailization is not a valid concern. Hedge funds should be made more, not less, accessible to unsophisticated investors. Already subject to government oversight, FOFs, institutional investors, and their managers serve as the protectors of unsophisticated investors exposed to the hedge fund industry. Although there are agency problems which exist in the institutional investor context, those issues will not be cured by imposing registration and disclosure requirements on hedge funds. They are problems which derive from the institutional investor model itself and require policymakers to reevaluate the regulations which govern that industry specifically.

C. Fraud

Finally, a concern that is only occasionally raised in support of the notion that the hedge fund industry should be subject to SEC regulation is the claim that hedge fund fraud is a rampant problem.[223] As evidence, some critics have pointed out that during the four year period between 2000 and 2004, hedge fund fraud was held responsible for investors losing approximately $1.1 billion.[224] Although abstractly this figure may seem substantial, one can hardly classify losing an average of $275 million annually to fraud as a rampant problem when the industry as a whole manages over $1.4 trillion in assets.[225] To put that figure in perspective, if the same amount were lost to fraud in 2007, it would represent a mere 0.019 percent of the industry.[226]

The SEC also points out that it has brought forty-six cases against hedges funds for allegedly defrauding their investors.[227] It argues that mandatory registration under either the Advisers Act or the Company Act would help avoid

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[219] *Id.*

[220] *Implications of the Growth of Hedge Funds: Staff Report to the United States Securities and Exchange Commission, in* 1466 PRACTISING LAW INSTITUTE, CORPORATE LAW AND PRACTICE COURSE HANDBOOK SERIES, 209, 235 (2005).

[221] *Id.*

[222] Shadab, *supra* note 28, at 39.

[223] *See, e.g.*, Tierney, *supra* note 15, at 599-600.

[224] *See* Pearson & Pearson, *supra* note 108, at 9.

[225] *But see id.*

[226] *Compare* Pearson and Pearson, *supra* note 108 (noting that over a four year period the industry lost $1.1 billion to fraud), *with* Vora & Gongloff, *supra* note 10 (stating that as of 2007, the hedge fund industry was responsible for managing in excess of $1.4 trillion).

[227] Mark J. Astarita, *Registration of Hedge Fund Managers—Bureaucracy Without Benefit*, http://www.seclaw.com/docs/New%20Hedge%20Fund%20Advisor%20Rule.htm (last visited Apr. 11, 2009).

fraud by permitting SEC examinations of hedge funds.[228] The claim is that because hedge funds will be subject to examinations, they will be less likely to engage in fraudulent activities.[229] The SEC also suggests that it will have the opportunity to preemptively intervene in order to prevent fraud because hedge funds will be required to supply the agency with financial and strategic information.[230]

To begin with, it is an open question as to whether the SEC is equipped with the necessary resources to effectively provide such oversight. The SEC, as of 2007, had a relatively small annual budget of $881 million,[231] or 0.031 percent of the government's fiscal year outlays that year.[232] An agency with only 3,100 employees, the SEC already appears financially strained.[233] In 2006, for example, it reduced its staff by 155 employees, and since then, has brought nine percent fewer enforcement actions.[234]

Pragmatics aside, it is a curious supposition that by providing the SEC with basic financial and strategic information, the agency will somehow be able to prevent a catastrophic incidence of fraud.[235] The regulatory system currently in place is designed to do just that for investors in public securities,[236] and quite frankly, it has proven to be unreliable. In recent years, there have been a number of scandals in which unsophisticated investors, invested in highly regulated industries, were defrauded. The SEC missed the Enron[237] and Tyco[238] corporate

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[228] Release No. 2333, *supra* note 132, at 72,058.

[229] *Id.*

[230] Release No. 2333, *supra* note 132, at 72,058.

[231] Frequently Requested FOIA Document: Budget History – BA vs. Actual Obligations [hereinafter "Frequently Requested FOIA Document"], http://www.sec.gov/foia/docs/budgetact.htm (last visited Apr. 11, 2008).

[232] *Compare* Frequently Requested FOIA Document, *supra* note 231 (noting that the SEC's total spending authority for 2007 was $881.56 million), *with* Office of Mgmt. & Budget, *Budget of the United States Government: Fiscal Year 2007* (2007), *available at* http://www.gpoaccess.gov/usbudget/fy07/pdf/budget/tables.pdf (last visited Apr. 11, (2008) (detailing total U.S. 2007 outlays of $2.77 trillion).

[233] Nelson, *supra* note 125, at 229.

[234] *Id.*

[235] *See* Tierney, *supra* note 15, at 592 (stating that "the SEC should re-focus its regulatory efforts on providing transparency within the hedge fund industry").

[236] *See* Chadwick, *supra,* note 31, at 767.

[237] Cathy Booth Thomas, *Called to Account*, TIME MAGAZINE, Jun. 18, 2002, *available at* http://www.time.com/time/business/article/0,8599,263006,00.html (last visited Mar. 1, 2009); Enron Scandal, http://encarta.msn.com/encyclopedia_701610398/enron_scandal.html (last visited Mar. 1, 2009). Once repeatedly tabbed as *Fortune* magazine's Americas Most Innovative Company, the severe 2001 downfall of Enron resulted from the revelation that its managers manipulated accounting methods to report false profits, and flee with millions of dollars, leaving investors and employees in bankrupt ruins. Thomas, *supra*; Enron Scandal, *supra*. Investor confidence was shattered as internal and external controls, including Enron's own board, accounting firms, credit-rating companies, and market analysts, all failed to provide sufficient oversight. Enron Scandal, *supra*.

[238] Timeline of the Tyco International Scandal, http://www.usatoday.com/money/industries/manufacturing/2005-06-17-tyco-timeline_x.htm (last visited Apr. 11, 2009). Shareholders were similarly deceived when Tyco's CEO, CFO, and chief legal officers deceptively used a program, intended to aid employee stock purchases, to take $170 million in loans, free of interest, and unapproved by their compensation committee for personal uses and gifts. *Id.*

governance scandals, as well as the mutual fund timing scandal.[239] The public received no word on the Enron or Tyco corruption until it was too late.[240] Similarly, the mutual fund timing scandal surfaced not because of any measures taken by the SEC, but because of whistleblowers.[241] The question for critics, then, is how can a system which has struggled to guard against even the most egregious cases of fraud be further stretched and relied upon to prevent fraud in the hedge fund industry? The answer is that barring an enormous and unprecedented dedication of government resources, it cannot.

The good news is that embarking upon a new antifraud scheme is unnecessary. Hedge funds, like every other issuer or investment entity, have always been subject to extensive antifraud requirements.[242] Hedge fund managers are considered legal fiduciaries pursuant to the Advisers Act, and as such, are required to make substantial disclosures to investors[243] and are expressly prohibited from making any "misleading statements" or "omissions."[244] Some hedge funds are subject to scrutiny from the Commodity Futures Trading Commission,[245] and if a qualified employee benefit plan owns twenty-five percent or more of a fund's equity assets, the fund must comply with the Employee Retirement Income Security Act.[246]

Hedge funds are also subject to a number of indirect restrictions. Regulation U of the Federal Reserve Board limits the ability of banks to lend to hedge funds.[247] Regulation T performs a similar function, restricting the lending power of securities broker-dealers.[248] Furthermore, pursuant to the new Basel Capital Accord,[249] member banks must comply with minimum risk-based capital requirements[250] and are required to make significant public disclosures of risk factors to financial markets.[251] The accord contains no express penalties, but failing to comply with these measures can result in "international regulators

[239] After years of duping unsophisticated investors, in 2003 it was discovered that prominent mutual fund companies were engaging in insider trading. Amey Stone, *A Primer on the Mutual-Fund Scandal—A ready reckoner to help investors understand Eliot Spitzer's crusade against late trading and other abuses*, BUSINESSWEEK, Sept. 22, 2003, *available at* http://www.businessweek.com/bwdaily/dnflash/sep2003/nf20030922_7646.htm. These companies warned preferential customers and partners of the purchase or sale of specific large stock positions. *Id.* Since mutual funds typically possess large positions in certain stocks such hefty selling/buying potentially impacted the stock value, thereby providing a lucrative profit to the trading partner. *Id.*

[240] *See supra* notes 242-43.

[241] Astarita, *supra* note 227.

[242] *See* 15 U.S.C. § 78(j); 17 C.F.R. § 240.10b-5. Federal securities law also prohibits hedge funds from engaging in insider trading. *See* 15 U.S.C. § 78(j); 17 C.F.R. § 240.10b-5.

[243] Shadab, *supra* note 28.

[244] *See* 15 U.S.C. § 77(p)(F)(2).

[245] Shadab, *supra* note 28.

[246] *Id.*

[247] *See* 12 C.F.R. § 221(u).

[248] *See* 12 C.F.R. § 221(t).

[249] Bitpipe.com, Basel II, http://www.bitpipe.com/tlist/Basel-II.html (last visited Apr. 15, 2008). The Basel Capital Accord is an international agreement that promulgates business standards for member banks. *Id.* There are approximately 56 member banks. *Id.*

[250] Shadab, *supra* note 28.

[251] Robert R. Bianchi, *The Revolution in Islamic Finance*, 7 CHI. J. INT'L L. 569, 572 (2007).

curtailing overseas operations, or market-enforced discipline."[252]

To the extent fraud persists in an industry, regulators should be exploring strategies to expel and prevent it from occurring in the future. Adopting a new and already broken system, however, is not the answer. Critics should instead be calling for more rigorous enforcement of current antifraud laws or the adoption of additional antifraud measures which fit into the current regulatory model.

IV. EFFECTIVE REGULATION, NOT MORE REGULATION

In the final analysis, there appears to be a strong emotional component behind the calls for subjecting hedge funds to SEC registration and disclosure requirements. With hedge funds having grown into "the modern day titans of industry,"[253] this fear-based response is understandable, especially in light of the growing number of established institutions either on the brink of collapse,[254] or in some cases actually failing.[255] Yet, when the details are fleshed out from behind this scary facade, it becomes clear that limited regulation, which allows hedge funds to maintain their unique status within the broader financial system, is the best solution.

Under the current system, hedge funds are permitted to voluntarily subject themselves to SEC regulation. Motivated by investors' demands for greater formal transparency, an increasing number of hedge funds are actually taking advantage of this voluntary process.[256] After the Hedge Fund Rule was struck down, a mere ten percent of funds withdrew their registrations,[257] leaving around 2,549—nearly one third of the industry—registered with the SEC as of 2006.[258] Since then, with managers seeking the government's venerable stamp of approval to better compete in the marketplace, the number of hedge funds choosing to register has continued to rise.[259] As Thomas R. Westle, a New York securities lawyer, explained

> [w]hen no one was registered, it wasn't an issue, but now institutional investors with a fiduciary responsibility to uphold are getting pickier. Now [hedge funds are] out there beating the bushes for new money, and if three funds are registered and

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[252] Dan W. Puchniak, *Perverse Main Bank Rescue in the Lost Decade: Proof That unique Institutional Incentives Drive Japanese Corporate Governance*, 16 PAC. RIM. L. & POL'Y J. 13, 43-44 (2007).

[253] Hall, *supra* note 86, at 184.

[254] *See, e.g.*, Shawn Tully, *Will the Banks Survive*, FORTUNE, March 16, 2009, *available at http://money.cnn.com/2009/02/27/magazines/fortune/obama_budget_tax.fortune/.*

[255] *See, e.g.*, Walter Hamilton and Peter G. Gosselin, *Wall Street Scrambles as Banks Teeter: Lehman Will File For Bankruptcy And BofA Will Take Over Merrill. The Fed Eases Emergency Lending Terms.*, LOS ANGELES TIMES, September 15, 2008.

[256] Glover, *supra* note 34.

[257] *Id.*

[258] Paul N. Roth, Hedge Fund Manager Registration in the Wake of Goldstein v. SEC 19 (Oct. 2006), http://www.srz.com/files/MARKETING%20-%20OCTOBER%202006%20-%20Hedge%20Fund%20Manager%20Registration%20in%20the%20Wake%20of%20Goldstein%20v.%20SEC.PPT#298,19,Slide 19 (last visited Mar. 29, 2008) (PowerPoint slide, Schulte Roth & Zabel International, LLP).

[259] Roth, *supra* note 258.

two are not, the [investor] might just check off those that are as options." 260

It is critical, for a number of reasons, that this strictly voluntary-based system be preserved. As was previously noted, adopting a mandatory registration model would require that funds make their investment strategies, positions, and client lists public information.[261] Different hedge funds, however, are likely to quantify the value of privacy differently. Those trading based upon new, cutting-edge theories, would seemingly consider privacy a highly valuable commodity. This is especially true if the fund is undersized or is in its start-up phase. Established hedge funds employing more traditional strategies, by contrast, are likely to have fewer privacy concerns. Considering that mandatory registration would exact a higher toll on certain funds, the information hedge funds reveal should be left to the funds and their respective investors to decide, not the SEC.

Similarly, unlike purchasing a publicly offered stock, hedge fund investors typically negotiate their purchase with fund managers.[262] These negotiations not only determine the price and amount of shares the investor will receive, but they also offer investors the opportunity to require that certain disclosures regarding investment strategies, backgrounds, and business operations be made.[263] Although negotiating for disclosure may have a material effect on the price of the investment—the greater the disclosure, the higher the price—the point is that investors should be permitted to weigh an investment's risks against its price, and then make concessions in either direction depending on their respective needs and comfort level. Mandatory registration models do not afford such freedoms. As Chairman Bernanke commented:

> Thus far, the market-based approach to the regulation of hedge funds seems to have worked well . . . [R]isk-management techniques have become considerably more sophisticated and comprehensive over the past decade. To be clear, market discipline does not prevent hedge funds from taking risks, suffering losses, or even failing—nor should it. If hedge funds did not take risks, their social benefits—the provision of market liquidity, improved risk-sharing, and support for financial and economic innovation, among others—would largely disappear.264

Unfortunately, as obvious as it seems that the mandatory registration of hedge funds is not the answer, it seems equally clear that the mounting pressure to pass new regulations will prohibit policymakers from remaining content with the current system. Since the Hedge Fund Rule was struck down, Congress has proposed a number of different bills, each a slightly different attempt at circumventing the *Goldstein* decision. The most recent bill was a bipartisan measure proposed on January 29, 2009 by Senators Chuck Grassley and Carl Leven, appropriately dubbed "The Hedge Fund Transparency Act of 2009."[265]

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[260] Glover, *supra* note 34.

[261] Glover, *supra* note 34.

[262] Paredes, *supra* note 18, at 992.

[263] Shadab, *supra* note 28.

[264] Econbrowser, *Hedge Fund Regulation*, http://www.econbrowser.com/archives/2007/04/hedge_fund_regu.html (last visited Mar. 29, 2008) (quoting Ben Bernanke).

[265] S. 334 of the 111th Congress, available at http://www.liveoffice.com/pdf/HedgeFundsBill.pdf.

While it remains unclear how this latest proposal will be received, it is indicative of the strong push for mandatory transparency-based regulations. As such, the question it seems policymakers will soon be confronted with is how to best address the concerns raised by critics without incurring the costly side effects of the mandatory registration model.

A. Increase the regulations imposed on hedge fund creditors

One of the more straightforward solutions would be to limit the amount of credit public financial institutions are permitted to extend to hedge funds. Perhaps the most significant concern expressed by those critical of the hedge fund industry is systemic risk. As alluded to earlier, one of the principal causes of systemic failure is failure amongst credit institutions, or more specifically, banks. When a market shift threatens the financial stability of overextended banks, credit markets dry-up, and consequently, industries unrelated to the shift are put at risk. However, if banks are limited in the credit they are permitted to extend to hedge funds, any failure of such funds would be less likely to instigate a liquidity crisis. With the government regulating financial institutions' exposure to the industry, any potential domino effect stemming from a hedge fund's collapse would be contained, as the solvency of its lending institutions would not be at risk.

Furthermore, regulating banks would be considerably easier given the regulations currently in place in both the banking and hedge fund industries. Banking is a unique industry which, because of its intimate involvement with the general public, is already subject to extensive regulation.[266] With the Treasury Department and Federal Reserve serving as the industry's watchdogs, restricting the amount of credit banks are permitted to extend to hedge funds would be a relatively seamless addition to the existing regulatory fabric. Banks and regulators are accustomed to dealing with ample regulation, whereas the mandatory registration system proposed by critics would require imposing an entirely new regulatory philosophy on an industry which has never had a regulator or been subject to extensive restrictions. Both regulators and hedge funds, moreover, would be required to implement a new system and iron out its inevitable pragmatic problems, a process which promises to delay any effects it might have.

Even more important than the ease of implementation issue is the efficacy of the regulatory strategy itself. Adding a regulatory layer to the banking system should prove to be a more successful approach than imposing a new regulatory scheme on hedge funds. Under the proposed mandatory registration model, regulators would consistently be one step behind hedge funds, relying on various disclosures to ensure compliance. The banking strategy, on the other hand, assumes a proactive approach whereby compliance with regulations prevents problems from ever arising in the first place. The focus on prevention, rather than

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The bill proposes deleting Sections 3(c)(1) and 3(c)(7) from the Company Act, thereby including within the definition of an "investment company" those entities which have heretofore been excluded from registration and disclosure requirements because they have 100 or fewer beneficial owners or because their securities are owned solely by "qualified purchasers." *Id.*

[266] Reid A. Horovitz, *Prohibiting Secondary Boycotts Against Banks: Protecting The Public's Interest*, 9 ANN. REV. BANKING L. 611, 623-24 (1990).

eventual detection and deterrence, should not only instill greater confidence in the regulatory system's ability to protect the public, but should prove more successful at achieving that end.

B. Enact more stringent regulations for the intermediary investment vehicles

Another option, which may be implemented in place of, or as a supplement to, any increased regulation of hedge fund creditors, is enacting more stringent regulations governing intermediary investment vehicles. As is the case with the banking industry, FOFs and institutional investors are also subject to government oversight. Additional regulation of these entities, therefore, will for essentially the same reasons be less drastic, more effective, and more easily implemented than any system imposing direct restrictions on hedge funds. FOFs, for example, could be required to increase their minimum investment thresholds to levels that sift out the more vulnerable investors who are less equipped to financially withstand a substantial loss. Depending upon the extent to which regulators are concerned with retailization, the minimum investment amount could also be required to be coextensive with those of hedge funds. The evidence indicates, however, that a certain amount of retailization is desirable, and that by increasing these minimums to such exorbitant amounts, the entire FOF industry along with its modest retailization effects will be lost. Still, this is preferable to embarking on a whole new era of regulations that would, in essence, render hedge funds the equivalent of mutual funds.

Institutional investors could similarly be prohibited from investing more than a certain percentage of their holdings with hedge funds. Such a move would permit unsophisticated investors to continue to realize benefits from holding hedge fund investments while permitting the government to regulate the extent of that exposure. It would also solve the agency problems such entities present because managers would be legally prohibited from overexposing their intermediary investment vehicles to the hedge fund industry. By limiting unsuspecting investors' exposure to hedge funds, managers of these institutional investment entities would be able to continue investing in hedge funds as a means of diversifying their holdings while the government can assure the investing public that their investments will not be overexposed to unregulated securities.

C. Relax the regulations imposed on mutual funds

Ironically, one of the more effective means of addressing the critics' concerns about the lack of hedge fund regulation may be through deregulation. If the regulations imposed on mutual funds were relaxed, policymakers would increase the competition for hedge fund business. Under current standards, mutual funds are required to hold substantial amounts of liquid assets, are severely restricted from engaging in short sales or the use of leverage, and are subject to management fee restrictions.[267] The suggestion is not to abolish these regulations; as such a move would effectively destroy the mutual fund industry and the value it

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[267] Edwards, *supra* note 17, at 38.

provides investors. Instead, the proposal is to curtail some of the restrictions imposed on mutual funds in order to allow them to compete with their hedge fund counterparts. If mutual funds had more freedom to utilize investment tools such as shorting, for example, they would be able to offer investors absolute return strategies, one of the main draws to hedge funds.

By opening up the competition for hedge fund business to entities that are subject to government restrictions, policymakers will likely motivate an even greater number of hedge funds to voluntarily register with, and make disclosures to, the SEC. Mutual funds will have the competitive advantage of being able to offer investors a greater degree of security because they are subject to government oversight. Hedge funds will either be forced to concede a potentially significant portion of their industry to mutual funds, or to compete by subjecting themselves to similar regulation. Although deregulation will have the effect of increasing the transparency of some funds, it will also permit those placing a premium on the value of privacy to keep their strategies confidential. Relaxing regulations imposed on mutual funds will, moreover, assuage the critics' concerns by increasing the industry's overall transparency, but it will not come at the high price of potentially destroying a beneficial industry.

D. Grant hedge funds proprietary rights over their investment strategies

A common complaint registered by those skeptical of these critics' reform proposals is that subjecting hedge funds to the SEC's registration and disclosure process will undercut the motivation for creating new strategies.[268] This process consists of combing through a fund's entire investment procedure and making it public.[269] Hedge funds rise and fall based on the effectiveness of their investment strategies, and once made public, the profitability of any novel strategy declines precipitously. This fundamental incompatibility between transparency-based regulation and the hedge fund industry is likely to be one of the primary reasons certain funds choose not to voluntarily expose themselves to the SEC. The solution, however, seems relatively straightforward: upon a fund's initial registration and disclosure filing, grant it an immediate, legally enforceable, proprietary right in its investment strategies.

Notably, if hedge funds were granted proprietary rights in their investment strategies, there would be numerous details policymakers would be required to iron out. Even more importantly, in and of itself, such a right would be unlikely to serve as a satisfactory solution for the critics' concerns. It is doubtful that hedge funds would be sufficiently motivated to voluntarily divulge their most sensitive information simply by guaranteeing them a legally exercisable right over a particular investment strategy. For starters, hedge funds would almost certainly question the practical enforceability of such rights. For a proprietary right to have any meaning, the hedge fund to which it was granted must be prepared to defend that right, a potentially lengthy and costly proposition. As many of the smaller

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[268] *See, e.g.*, Shadab, *supra* note 28 (noting that federal securities laws prohibit hedge funds from fraud and insider trading).

[269] Glover, *supra* note 34.

funds would likely point out, the ability to financially survive protracted litigation will correspond with a fund's size, thereby advantaging the larger, more established, funds.

Although proprietary rights may not be the regulatory solution for addressing the various concerns of the hedge fund critics, they should nonetheless serve as a fair and effective supplement to any measures which either make registration and disclosure mandatory or seek to build on the current voluntary system. Proprietary rights will preserve the incentive for hedge funds to continue developing new investment techniques and strategies, and thus help protect the industry as a whole.

V. CONCLUSION

Hedge funds have been elevated to near-mythical status in recent years as they have come to control an ever expanding portion of the world's financial markets.[270] At first blush, the notion that more than $1 trillion is being moved around the world's economy without having to answer to any government authority is a frightful proposition. A closer look, however, reveals that even though the government's regulatory eye does not follow monies invested in the hedge fund industry directly, the current regulatory model has created a system which exerts effective indirect controls over such investments. It is a system which affords numerous benefits to both investors and broader financial system alike, and has shown no real evidence of inadequacy. Moreover, the transparency-based model that is being touted by some carries potentially devastating side effects. The bottom line is that to the extent concerns relating to the present regulatory model exist and require regulatory action, policymakers should explore alternatives within the current framework before tossing the baby out with the bathwater.

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[270] *See* Charles J. Gradante, *Comments of Hennessee Group LLC for the U.S. Securities and Exchange Commission Roundtable on Hedge Funds* 4-5 (2003), http://www.sec.gov/spotlight/hedgefunds/hedge-gradante.pdf (noting that hedge funds grew from $20 billion in 1987 to $35 billion in 1992 to $50 billion in 1993, and from there to about $600 billion as of January 2003).